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National City Monthly Letter on Business and Economic Conditions

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General Business Conditions

THE opening weeks of the new year have brought no pronounced change in business. Further reports of factory curtailment, with rising claims for unemployment compensation, have emphasized the recession in industrial operations. New orders for steel and nonferrous metals, which reflect conditions in a great many industries, have been sluggish. Projected automobile assembly schedules have been cut down somewhat. Nevertheless, automobile output during January has been larger than in December, and the same is true of some other important lines. It is safe to say that the decline in the industrial production index, which averaged a little over 1 per cent a month in the second half of 1953, has been comparably modest. Merchandise markets and retail sales generally have made a good showing.

Both in industry and trade these developments accord with most ideas about the business outlook. It is clear that a change of policy from inventory buildup to inventory reduction set in last fall, representing an adjustment to increased supplies, prompter deliveries, and, relatively speaking, buyers' markets. This is still in effect. With demand diminished, production has naturally slackened. Most people think the contraction will go farther. On the other hand, the opinion that consumption will be relatively sustained, and that a high level of everyday trade will provide an anchor against spiralling downward tendencies, has found support in current sales figures.

In the fourth quarter of 1953, consumers purchased goods and services at the annual rate of $230.5 billion, approximately the same as in the previous two record-breaking quarters. For January, reports indicate little slackening. Department store sales have matched those of a year ago, despite severe weather, and seasonal white sales showed a pronounced gain. More buyers were in the New York wholesale markets during the month, and they bought more goods than many had expected.

Government figures indicate that inventory accumulation had ceased by the end of September last year. During the peak second quarter of 1953, business was adding to stocks at the rate of about $7 billion a year (seasonally adjusted). In the fourth quarter, according to the President's Economic Report, inventories showed no change. This drop in demand for inventory purposes was a little greater than the drop in the aggregate production of goods and services (gross national product) in the same period, which was $5.7 billion, annual rate. Thus the change in the business situation is measured essentially by the decline in inventory buying. The demand for goods and services otherwise — including personal consumption, construction, plant and equipment, and government purchases — has remained at or close to peak levels.

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An Example of Confidence

Speculative security and commodity markets have been strong, which seems to show that business is not suffering any great loss of confidence. The Administration's economic program, as outlined in the various messages during the month, includes measures by which enterprise and investment unquestionably will be encouraged. The most dramatic example of confidence and leadership has been given by the announcement of Mr. Harlow H. Curtice, President of General Motors, that the Corporation would spend a billion dollars on plant and equipment in the next twenty months, or $600 million in 1954, compared with an average of $250 million annually since the war. Mr. Alfred P. Sloan, Jr., Chairman of the Corporation, added that the capital program may even run to $1½ billion in three years, and he said that if the additional capacity is not actually needed when it is completed, it will inevitably be required in the end by the growth of the country.

Not all business organizations are as able as General Motors to build ahead with as little regard for a possible interim recession, but the example nevertheless should encourage everyone. What General Motors is saying is that if expansion is premature, demand will nevertheless catch up rapidly, under the influence of population growth and technological progress, and that if a mistake of overoptimism is made it will not be a mistake very long.

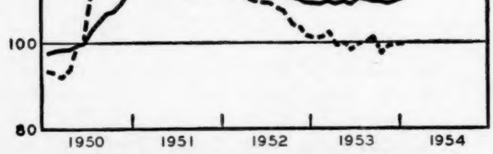
Implications of the Budget

The budget submitted by President Eisenhower during the month calls for a cut in expenditures during fiscal 1955 of $5.3 billion from the fiscal 1954 total. Most of the reduction is concentrated in funds for the Army and Navy, but the Air Force and atomic energy programs will be stepped up. The volume of new government contracts awarded is declining much more than expenditures. The government, like many business men, is trying to get its budget under better control, whittling down the vast backlog of commitments and authorizations for future spending. Manufacturers have already felt the effect of this program in the declining backlog of unfilled defense orders.

The impact of lower government spending and ordering on business has the stimulus of tax reduction as an offset. On the whole, the President expects budget receipts to fall short of expenditures in both fiscal 1954 and fiscal 1955 by approximately $3 billion. Cash income and outgo for the two years will be approximately in balance. These estimates, however, are based on Treasury assumptions that a stable and prosperous economy will be maintained through mid-1955. It is assumed that personal income and corporate profits will continue over the next eighteen months at approximately the same levels as in late 1953. Revenue estimates are also based on the expectation that Congress will follow the President's recommendation for deferring tax cuts scheduled for this spring. Should these anticipations be too optimistic, a larger deficit may emerge.

The Stability of Prices

Staple commodity prices during this period of recession have held their ground very well. Ordinarily, when business activity turns down, prices decline also. Today, however, commodity price indexes show none of the weakness usually associated with declining production, employment and orders. A high degree of stability has persisted for more than a year in average wholesale and consumer prices, and for nearly that long in basic commodity price indexes. The inference is that the staple commodity markets as a whole are not particularly vulnerable, and if that is true the reason undoubtedly is that many commodities had already gone through a corrective decline, and found support levels of either a natural or an artificial kind, well before business turned down.



Indexes of Prices of 22 Basic Commodities and 2,000 Wholesale Commodities. June 1950=100.

As the chart shows, an index of basic commodities rose more than 50 per cent in the first eight months of the Korean war, but dropped back to pre-Korean levels in the following two years. Thus the speculative "boom and bust" associated with Korea, as far as prices are concerned, was behind us nearly a year ago. The excesses have been largely wrung out. In pre-

vious recessions, the liquidation of speculative stocks acquired at high prices has frequently intensified the downturn, but declining prices in 1951-52 and widespread talk of recession possibilities during 1953 discouraged accumulation. Meanwhile credit has eased, rising industrial production abroad has brought foreign demand into the markets, and in several cases prospects of natural or artificially created shortages have had a marked effect. The steep rise in coffee and cocoa prices in early January stems from sharply reduced crops in the face of increasing world demand. For several important farm commodities, the government price support programs have reduced free market supplies and thus have created the prospect of an end-of-season squeeze in private supplies.

The more comprehensive index of wholesale prices has leveled off, but it is higher than in early 1950; increased costs and the usual relative insensitiveness of finished goods included in the wholesale price index have dampened changes in this more comprehensive measure. In fact, wholesale prices of industrial goods (commodities other than farm products and foods) have leveled off only 2 per cent below their March 1951 peak. However, some effective price reductions, such as absorption of freight charges by steel mills, are not reflected in the published quotations.

While the general price level has been stable, prices have not been stagnant. Instead, they have constituted an outstanding example of the now popular phrase, "rolling readjustment". Prices of individual commodities have had marked ups and downs, and the process of adjustment has continued.

Foreign observers who have been anxiously fearing a "collapse" of the American price structure may find that that event took place over two years ago in an orderly, rather than catastrophic, fashion. As the London Economist observed a few weeks ago, "commodity prices now seem rather too low for the current level of world output". If that is the case, one reason is that they have been discounting recession and slackened demand.

Treasury Debt Refinancing

The Treasury launched on January 27 its largest refunding operation since the new Administration took office — indeed the largest in the history of the country — when it announced offerings of new securities in exchange for $20.8 billion out of the $40.7 billion of marketable bonds, notes and certificates falling due, or callable for payment, during the first half of 1954. The Treasury offered seven and three-quarter year bonds, maturing November 15, 1961 and paying a rate of 2½ per cent, to holders of the securities listed in the table below:

(In Millions of Dollars)

	Official Holdings	Public Holdings	Total Outstanding
2¼% certificates maturing 2/15/54	$3693	$4421	$8114
1⅞% notes maturing 3/15/54	245	4430	4675
2% bonds maturing 6/15/54	455	5370	5825
2¼% bonds maturing 6/15/55 to be called for payment 6/15/54	101	1400	1501
2¼% bonds maturing 6/15/56* to be called for payment 6/15/54	—	681	681
	$4494	$16302	$20796

*Partially tax exempt. Other issues fully taxable.

The holders of the 2¼ per cent certificates due February 15 and the 1⅞ per cent notes due March 15 were given an alternative choice, if they did not want the new bonds, of exchanging their holdings for one-year certificates of indebtedness due February 15, 1955 and paying a rate of 1⅝ per cent. Subscription books were opened for the three-day period, February 1-3, the actual exchanges to be carried out February 15. A premium of about ⅜ point was being offered for the exchange subscription rights on February 1, indicating a strong demand, predominantly from banks, for the new 2½ per cents.

This refinancing operation could produce the largest marketable bond issue in history. Leaving aside the $4½ billion of securities eligible for exchange held by official accounts, mainly by the Federal Reserve Banks, the presumption is that the bulk of the public's $16.3 billion of the securities involved will be exchanged for the bonds. The largest marketable bond issue previously put out by the Treasury was the $11.7 billion Victory Loan issue of December, 1945. This issue also paid 2½ per cent, although most holders accepted the Treasury's invitation in the spring of 1951, when the bond market was unpegged, to exchange their holdings for 2¾ per cent nonmarketable bonds.

In view of all the ill-advised comments last spring that the Treasury was intent upon moving the public debt onto a 3¼ per cent basis, it is worthy of note that this present exchange operation promises to button up a large segment of the debt for 7¾ years at 2½ per cent.

Favorable Market Conditions

For launching this operation the Treasury had the most favorable conditions in years. Bank loans, after failing to expand as much as usual from August through December, declined in

January more than customarily would be expected. Return flow of currency to the banks following Christmas exceeded expected proportions, while radically reduced yields on short-term Treasury obligations repelled investments of cash reserve funds by customers, thus swelling bank loan resources.

Federal Reserve policy, moving toward easier and easier conditions in the money market, allowed surplus funds to mount up, accelerating the decline in yields on short-term governments and multiplying the pressure on banks to find earning assets which would provide a better rate of return. At times during January yields on ninety-one day Treasury bills dropped to 1 per cent or less, the first time this has happened since 1949.

These conditions, together with anticipations of further decline in business, fanned the flames of bull sentiment in the bond market. At their peak in January, for example, the Treasury thirty-year 3¼s, sold May 1 last, traded at 106⅞, reducing the yield to 2.86 per cent. The 2¾ per cent bonds of 1961, sold November 9, went as high as 102⅞ before reacting under the influence of the new 2½ per cent offering.

In announcing the February 15 refinancing operation, the Treasury indicated that consideration is being given to the sale of a longer term bond for cash. The public debt limit now precludes cash borrowing to improve the undesirably low level of Treasury cash balances. The maturity on March 22 of $5.9 billion tax anticipation certificates will drain off the heavy surplus revenues of March but at the same time give leeway, within the debt limit, for borrowings to cover the normal April and May deficits.

Liberalization of Depreciation Rates

Among revisions in tax legislation proposed by President Eisenhower in his budget message and already approved by the House Ways and Means Committee, the proposal to allow greater freedom in depreciation rates is especially noteworthy as a much needed encouragement of capital investment to improve and expand industry.

In computing federal income taxes under existing law, the cost of business plant and equipment is ordinarily charged off as an allowable expense spread over the estimated life of the property. Such life span varies widely, depending upon many factors. The Treasury has developed over the years an elaborate schedule of rates to be applied in different industries and to different types of property. They range in typical cases from small cutting tools, which may be charged off completely in the same year purchased, to apartment houses, given an estimated life of 50 years and chargeable at a rate averaging only 2 per cent annually. Some machines are given a life of 25 years, gas plants 50, grain elevators 75, steel-and-concrete bridges 100, and water supply dams 150 years.

Business men have long contended that the tax provisions are unrealistic because of the long life estimates and resultant low rates of permissible depreciation. They cite repeated instances where the economic life of property has proven to be only a fraction of its physical life, due either to obsolescence or to a waning in demand. When a business finds itself holding property that has become obsolete, but whose cost has not yet been recovered through charges to depreciation, the consequences may be serious. The inadequacy of prior years' charges for depreciation results in an overstatement of real earnings, and an overpayment of taxes based thereon. At the same time, a sudden writing off of a substantial unamortized excess in asset valuation on the balance sheet causes a corresponding cut in the shareholder's or proprietor's book equity and distorts the current income account.

Business men, mindful of the uncertainties of the distant future and impressed particularly by the speed-up in technology and thus in obsolescence, have urged that the tax laws be liberalized to permit depreciation to be charged off faster in the useful economic life of the property, instead of being spread uniformly. This would provide greater assurance of recovering the cost of new capital investment.

In order to correct the widely-conceded inequities of present tax provisions for depreciation, the President made the following recommendation in his budget message:

> A liberalization of the tax treatment of depreciation would have far-reaching effects on all business and be especially helpful in the expansion of small business whether conducted as individual proprietorships, partnerships, or corporations. At present, buildings, equipment, and machinery are usually written off uniformly over their estimated useful lives.
>
> The deductions allowed, especially in the early years, are often below the actual depreciation. This discourages long-range investment on which the risks cannot be clearly foreseen. It discourages the early replacement of old equipment with new and improved equipment. And it makes it more difficult to secure financing for capital investment, particularly for small business organizations.
>
> I recommend that the tax treatment of depreciation be substantially changed to reduce these restrictions on new investment, which provides a basis for economic

growth, increased production, and improved standards of living. It will help the manufacturer in buying new machinery and the storekeeper in expanding and modernizing his establishment. It will help the farmer get new equipment. All of this means many more jobs.

Specifically, I recommend that business be allowed more freedom in using straight-line depreciation and in selecting other methods of depreciation. Larger depreciation charges should be allowed in the early years of life of property by the use of the declining-balance method of depreciation at rates double those permitted under the straight-line method. Other methods which give larger depreciation in early years should be accepted, so long as they do not produce deductions which exceed those available under the declining-balance method.

Prompt approval, in principle, of a change along these lines in the depreciation provisions was announced by the House Committee. Full details have not been given out, but it was stated in the press that the Committee had provided for: (1) binding agreements on depreciation rates to be made between the taxpayer and the Treasury; (2) the choice by the taxpayer from a number of different methods for computing depreciation; and (3) the use of the taxpayer's preference in depreciation rates where they differ by less than 10 per cent from the Treasury's.

These changes are to apply mainly to investments in buildings, machinery and equipment made after January 1, 1954. They would include farm buildings and equipment, and new construction of commercial and industrial buildings and rental housing.

Not a "Gift"

The changes do not constitute — as has sometimes been alleged — a "gift" to business. Neither is the issue chiefly one of saving taxes over the long run, inasmuch as any tax reductions during the years of accelerated depreciation would be offset by tax increases when the depreciation charges decline or end entirely. Depreciation may be charged off only once; after the total cost allowance has been used up, no further expense deduction is allowable. The President noted that faster depreciation would not increase total deductions, but merely shift them from later to earlier years. He suggested that the change should, in fact, increase government revenues over the years because of the stimulus to enterprise and expansion.

Actually, while the more realistic treatment of depreciation approved by the Committee is everywhere commended, the revisions do not go as far as many interested persons had hoped for. Although the option of using a declining-balance method for computing depreciation, or an acceptable variation thereof, results in a faster recovery of costs during the early years than does the more familiar straight-line method, it still does not pay out fast enough on many types of equipment and, in addition, is sometimes criticized as too inflexible.

During the Committee hearings on the subject last summer, a proposal receiving wide circulation was to permit the taxpayer to write his own ticket as to rates of depreciation, subject to the limitation of writing off no more than 50 per cent of total cost during the first five years. Such a speed-up would permit a much faster, and therefore more certain, recovery than at present on new capital investments having estimated useful lives running to 20, 30, 40, 50 years and even longer. Future tax revision granting taxpayers greater freedom of judgment in this respect would be a logical next step. Meanwhile the pending amendments promise, as President Eisenhower stated, "a basis for economic growth, increased production, and improved standards of living."

Economic Policy in Recession

There has been a widening interest over recent weeks and months in the question of what the Government should do in the event of a serious business recession. The importance the President attaches to the problem was evidenced when he appointed as chairman of his Council of Economic Advisers Arthur F. Burns, former research director of the National Bureau of Economic Research and a distinguished expert on business cycles. The Council, aided by an interdepartmental Board on Economic Growth and Stability, has been giving the question continuous study. Congressional committees, leaders of business, agriculture, and trade unions, with the help of their economic advisers, have also developed ideas with particular reference to the possibility that the programmed curtailment of defense outlays might set in motion a spiralling business contraction.

The President has given assurances from time to time that the Federal Government would be ready to act in the event of a recession. In his annual State of the Union message, January 7, emphasizing the needs for "economic preparedness", he listed seven areas for action to facilitate a "transition from a wartime to a peacetime economy" without "serious interruption in our economic growth":

(1) Flexible credit and debt management policies

(2) Tax measures to stimulate consumer and business spending

(3) Suitable lending, guaranteeing, insuring, and grant-in-aid activities
(4) Strengthened old age and unemployment insurance measures
(5) Improved agricultural programs
(6) Public works plans laid well in advance
(7) Enlarged opportunities for international trade and investment

Two Schools of Thought

A year ago, when business was at the crest of the boom, the question of what Government should do in recession seemed academic. Today it appears as a practical problem. Since last summer, seasonal factors considered, there has been a measurable recession in production and in employment opportunities. Expectations of further contraction have been widespread. What does the Government do if these expectations prove to be correct?

There are, broadly, two extremes of view. One view places the emphasis on government spending beyond its revenues to increase the supply of money purchasing power. The idea is that there is a gap in demand that has to be filled by creating and spending more money. The other view places the emphasis on processes of natural adjustment, letting the producer cut out waste and shake his costs and prices down to a point that stimulates demand. Where government places its emphasis — whether on increases in government outlays or on encouragements to natural adjustment — has a great deal to do with the future course of prices.

The first item on President Eisenhower's list has already been applied. Since last summer the Federal Reserve and Treasury authorities have brought credit and debt management policies flexibly into play on the side of easing the supply of credit, encouraging lenders not only to extend maturities for temporarily embarrassed borrowers but also actively to solicit mortgage and other loans. The easy money policy is being applied with such vigor, indeed, as to involve a risk of laying the basis for another round of inflation. On the other hand, the danger is mitigated by the fact that government outlays are being cut back. Moreover, the easier credit policies can be reversed quickly.

Tax Measures

The President's second item, tax measures to stimulate consumer and business spending, also is being brought into play, though within the compass of a balanced budget objective. On January 1 personal income taxes were eased about 10 per cent and the corporate excess profits tax expired. The President's further tax recommendations, twenty-five in number, involving some additional revenue loss, are intended to remove the more glaring tax inequities, reduce restraints on the growth of small business, and encourage initiative, enterprise, and production.

The President's third item — "lending, guaranteeing, insuring, and grant-in-aid activities" — is in play under existing programs. For example, within limits set by Congress, the FHA is insuring home mortgages and the Federal Government is supplying portions of the funds used by the States in such diverse activities as highway construction and support of needy and disabled persons. In a serious recession, these insurance and grant-in-aid activities could be expanded.

In a special message on housing, January 25, President Eisenhower pointed out that: "Because inflationary or deflationary pressures can be accentuated or diminished by mortgage credit terms, Government operations in connection with the insurance or guarantee of mortgage loans should be judiciously adjusted to prevailing economic conditions."

While he held a high level of housing construction as "essential", and asserted that the Federal Government "must provide aggressive and positive leadership", the President did not urge any attempt to increase the rate of housing construction from the high level sustained over recent years, and warned against "actions and programs . . . that would make our citizens increasingly dependent upon the Federal Government to supply their housing needs."

"Strengthened old age and unemployment insurance measures", the fourth item, would help steady the demand for goods. It must always be borne in mind that the cost of social security programs represents a burden on the working population and that benefits which are too generous detract from the will to work and from the national output. On the other hand, a stand-by source of income in depression relieves not only hardships but also the drop in spending that lay-off, retirement from the labor force, or disability otherwise involves. The President's recommendations for broadening the old-age and unemployment systems went to Congress January 14.

Administration plans for "improved agricultural programs", the fifth item, are also under Congressional study. The present program imposes a double cost on the consumer: he is taxed to provide funds for the Government to use to keep farm products off the markets and his food costs are raised. The emphasis of proposed new programs is on restoring greater price flexibility,

relieving the strain on the federal budget, allowing more of the farm production to enter the channels of consumption, and requiring the farmer to adjust his production to what the consumer, at home and abroad, wants. These aspects are addressed to the longer-term welfare of the country and to the promotion of trade, rather than to any threat of business recession. The proposed program would still protect the farmer from radical curtailment of income through precipitous price declines.

Public Works

"Public works plans laid well in advance," the President's sixth item, is sound in principle though past experience has not been encouraging. Planning public works has been prone to create demands for getting projects under way. There is every merit in planning ahead provided Congress and the Administration have the fortitude to hold projects back to a time when construction labor and materials are in excess supply and provided also that the projects do not displace programs which private enterprise could and should pursue.

Today there is no real slack in the construction field. Holding back projects, save those of highest importance, assists budget-balancing and is wise policy on every count.

The final item included on the President's list is "enlarged opportunities for international trade and investment." Here he evidently has in mind easing barriers to international trade and capital movements, including the discriminations against American goods that industry and agriculture face in their access to export markets.

Confidence in Individual Initiative

What stands out above all else in the President's messages is his faith in the initiative, responsibility, and stable judgment of the individual, given a removal of government deterrents and an environment for confident planning ahead. In the State of the Union Message he said:

> A government can strive, as ours is striving, to maintain an economic system whose doors are open to enterprise and ambition — those personal qualities on which economic growth largely depends.
>
> But enterprise and ambition are qualities which no government can supply. Fortunately no American Government need concern itself on this score; our people have these qualities in good measure.

These principles have tangible recognition in recommended tax policies:

> It is the determined purpose of this Administration to make further reductions in taxes as rapidly as justified by prospective revenues and reductions in expenditures. The objective will be to return to the people, to spend for themselves and in their own way, the largest possible share of the money that the Government has been spending for them.
>
> The start toward tax reductions is justified only because of success in reducing expenditures and improving the budgetary outlook. That outlook permits me to make some proposals for tax reform and reductions for millions of taxpayers at this time which represent much-needed improvements in our tax system.
>
> These proposals are directed toward removing the most serious tax hardships and tax complications, and reducing the tax barriers to continued economic growth. The proposals will encourage the initiative and investment which stimulate production and productivity and create bigger payrolls and more and better jobs.

The same theme is implicit in the section in the State of the Union Message dealing with measures to combat recession:

> If new conditions arise that require additional administrative or legislative action, the Administration will still be ready. A government always ready to take well-timed and vigorous action, and a business community willing, as ours is, to plan boldly and with confidence, can between them develop a climate assuring steady economic growth.

The President's philosophy, visible in every one of his messages, rejects income-equalizing doctrines, so much popularized in recent years, which would appropriate increasingly the fruits of incentive and enterprise for the heads of government bureaus to disburse. It is a breath of fresh air, invigorating to everyone possessed of the yearning to assume the mastery of his own fate, to work to get ahead in life, to dispense his own benefactions, and to see a land of opportunity open to his children.

Boom and Bust

In a free economy people are free to change their minds about what, when, and where to buy, to respond to attractive merchandise at an attractive price and to reject unattractive wares at an unattractive price. The employee's job depends upon the employer's ability to make a profit. This in turn depends on the will and effort of the employee, the tools put in his hands, the quality and price of the product, and the response of the consumer to the sales effort. When sales fall off the employee is under pressure to do a better day's work. The employer is under pressure to put on a harder sales effort, to correct his inventory position, to cheapen production methods, to improve quality, and to design products that will find willing buyers.

Economic progress depends on these efforts and adjustments being made. The consumer, the

employer and the employee all stand to benefit. These kinds of adjustments are going on in some degree practically all the time. When sales fall off in a good many lines of business at the same time we have a recession and a bunching up of needs for readjustment. These readjustments do more good than harm. Ideally it would be better to have readjustments evenly distributed over time. But no one has ever figured how to do this in a free society. And it is better to have bunchings of readjustments than none at all. In the latter case, the consumer would always be getting the short end of the stick.

Recessions have to be watched closely. Falling sales volumes, increasing business failures and credit losses, can gain momentum leading to deep depression when pressures to deflate prices and costs become acute and universal. Depressions impose unwarranted hardships; the readjustments are not worth their cost.

Long and deep depressions are rare. Moreover, they can be avoided. This is easier to say than to accomplish. In boom the human tendency is to be carried away on a wave of overconfidence, to overborrow and overspend. In such circumstances, government officials who pursue restrictive policies court unpopularity. Yet timely action to repress unbridled boom is the fundamental cure for depression.

The authorities in Washington displayed courage and foresight last spring in dealing with boom conditions. Paring the budget and restraining credit expansion at that time has moderated the proportions of the readjustment now under way. Booms feed on the spending of future income. They leave gullies of slow demand when they come to an end and excesses of borrowing and inventories are worked off. Booms bring into play high-cost production and high-cost producers who can thrive only in seller's markets. Inevitably uneven in their impacts, they bring maladjustments in price and cost relationships and in the distribution of goods and income. Recent months have seen a process of correction at work. No symptoms of collapse into depression are visible.

Business men and workers live with the reality of industrial fluctuations. If they are prudent they put something aside when times are good as reserves to tide over slow periods. These reserves, aided by income tax relief that comes automatically when incomes drop, and unemployment compensation offered under the Federal-State systems, hold declines in consumption to lesser proportions than declines in production and payrolls. Buying power is released to absorb surpluses of inventory and to set the stage for a build-up in production.

Escape via Inflation?

The most promising avenue for further stimulation of the economy, if needed, is additional tax relief. Such relief would be particularly helpful if it appeared that the lower rates would provide, under active business conditions, more than enough revenues to cover prospective government outlays. Tax reductions clearly of a temporary character would be of less value.

On the other hand, the view has been advanced that government, in recession or depression, should forget all ideas of a balanced budget, radically reduce taxes, radically increase outlays, and pump out so much money that trade would be forcibly enlarged. Save for the new ingredient of tax reduction, this proposal bears an unwholesome resemblance to the policy so long and unsuccessfully pursued to restore prosperity during the 1930's.

History never repeats itself exactly and it is impossible to foresee with precision how a program of planned super-deficits would work. Two things, nevertheless, are fairly certain: fears would be aroused of uncontrolled inflation and of radically increased taxes. These are ingredients of economic instability — not of stability founded on expectations of economic growth in an environment of confidence in the future.

In any prolonged recession the revenues of the Federal Government, so largely dependent on the flows of personal and business incomes, will melt away fast enough to create deficits of major dimensions. Such deficits can perhaps be tolerated so long as the tax and expenditure structures are scaled to bring a surplus of revenues when prosperity is restored. To throw discretion to the winds, to invite government department heads to compete to see who can spend the most money the fastest, is to destroy — not to build — a strong and secure economy.

The Question of When

There is a very real question as to when a downturn in business reaches a point warranting affirmative action. The CIO has been most articulate in demanding government action, basing its case on reduced employment opportunities and using as a specific example the agricultural implement industry. When the economic situation is viewed as a whole, however, it is apparent that the greater part of the shrinkage in production since last spring has been taken up in elimination of overtime work and withdrawals from the labor force of people not ordi-

narily employed. People looking for work, as estimated by the U. S. Department of Commerce, numbered 2,360,000 in mid-January. This is 3.8 per cent of a calculated civilian labor force of 62,160,000.

The question for government policy is not only what to do in a recession but when. If the Government should, by inflationary fiscal and credit policies, attempt to forestall all downward business adjustments, the outcome could hardly be anything except chronic inflation and perpetuation of the imbalances and injustices of an inflationary economy. In other words, it is wise for government to give natural readjustments some time and opportunity to work.

The usefulness of corrective adjustments frequently has been disparaged. In October 1948, the CIO, demanding "wise and vigorous government action to prevent depression", asserted:

> There is no comfort in the pious promise of business leaders that inflation will end with a general softening of demand which will reduce prices. When this happens there will also be a softening of production and the employment which it sustains. With slackening industrial output and rising unemployment we already will be in the cycle of the next depression.

Yet the diagnosis which the CIO attributed to business leaders proved out. The 1949 business recession ended in a natural rebound. No vast new government programs were launched, although the unemployment percentage peaked at 7.6 per cent in February 1950. The Truman Administration placed its faith in natural price and cost correctives plus the cushions represented in unemployment insurance, etc. This faith was warranted.

A Test for Fiscal Policy

In his book, "Economy in the National Government", published two years ago, Senator Paul H. Douglas of Illinois wrote an appendix on Federal Budgetary Policies in which he answered the questions as to when the Government might properly resort to deficit-financing to deal with depression. His views are of particular interest not only because he was a member of the party then in power but also because he is an economist who has made employment statistics a life-long study.

Senator Douglas suggested that a normal proportion of seasonal and transitional employment would run near 6 per cent and warned that it would be "very dangerous" to use deficit financing in order to drive unemployment below 6 per cent:

> . . . it will tend to do far more harm through inflation than the good it will do by absorbing some of those who are unemployed from seasonal and transitional causes.
>
> For in a period when unemployment is less than 6 per cent, there is no real supply of workers ready to go into productive activity. Instead, the unemployed are primarily either the hard core of the perennially unemployed, such as the handicapped, and the transitionally unemployed for whom job openings exist. Since there is no real idle supply of labor, extra money pumped into the economy by budgetary deficit cannot appreciably increase production. Rather, it will be used to bid up the prices on the available supply of goods and services, and hence it will bring about inflation.

Continuing, Senator Douglas submitted as a rough judgment:

> . . . probably we should not run a governmental deficit unless unemployment exceeds 8 per cent and, indeed, possibly slightly more than that. When unemployment is between 6 and 8 per cent, the governmental budget should at least balance and therefore be neutral in its effects.

Since the latest unemployment figure, that for January, was below 4 per cent, the time has not yet arrived—on the basis of Senator Douglas' test—when the Administration can view a deficit as a necessary and desirable stimulant to the economy.

In recent months Senator Douglas has expressed the view that there is some danger of a vicious downward spiral developing unless further steps are taken and he has specifically urged an increased program of public works. In a radio discussion with Senator Douglas and Gabriel Hauge, economic assistant to the President, December 27, Leon Keyserling, chairman of the Council of Economic Advisers in the Truman Administration and speaking, as he put it, "as an old New Dealer", confessed a lack of confidence in public works "to bring us out of a deep downturn" and asserted that the important thing now is to stimulate expansion of business investment. As Mr. Hauge pointed out, the tax program is the most effective thing that could be done to stimulate investment. Fruitful investment, after all, is the foundation for advancing standards of well-being for the people.

More on Social Security Taxes

The article in our January issue on the increase in social security taxes effective the first of that month has prompted a number of letters from readers taking issue with certain statements or suggesting points not covered. In view of the interest in the subject, as well as the basic character of some of the questions and suggestions, we are giving a brief supplement to last month's discussion.

In that article, discussing the case for and against the tax increase, we raised the question as to whether the collection of social security taxes in excess of social security disbursements and investing them in government securities is in fact essential to a "sound" social security program, as has been asserted; and whether it adds anything to the ability of the Government to meet social security obligations when due.

Our conclusion was in the negative on both counts. As we explained in the text:

> Money collected in social security taxes is not held as idle cash in the Treasury where it can be paid out in social security benefits when people retire. It is invested in government securities issued to the trust fund by the Treasury, and the money itself expended for general budgetary purposes just as are the proceeds of any other Treasury borrowing. At the same time the securities held in the fund serve as earning assets, the income of which is to pay retirement benefits as they fall due. Thus money to meet these interest payments and retirement benefits must be provided by taxes at the time these liabilities mature. In the final analysis, future pension payments, whether financed by an accumulated reserve of government securities or under a pay-as-you-go plan, can only be made out of taxes on income of the future.

The above statement was not meant to imply —as some critics of the reserve fund have — that there is anything reprehensible in the Government's exchanging its own IOUs for cash in the fund and spending the proceeds. As pointed out in our article, for the Government to hold the vast sums collected in social security taxes idle and uninvested would be wholly impractical and insupportable from every angle. These government IOUs are of course just as good in the money sense as are the government bonds held by private insurance companies, banks, and other investors. The fact, however, that they must be serviced as to interest and ultimately redeemed out of the taxes of the future does raise, as we stated, a question as to the wisdom and necessity of increasing taxes to build up a huge reserve fund in advance of actual needs.

Correspondents' Objections Considered

This question as to the validity of the reserve fund philosophy was one of the main points challenged by our readers. To quote one writer:

> Obviously, if there were no reserve not only would future taxes be necessary to pay for the benefits of persons not yet on the rolls but also for the benefits of persons already on the rolls which are now being paid out of taxes previously collected.
>
> If I may say so, I think you would have been on sounder ground if you had pointed out that, regardless of whether there is a reserve, future goods and services consumed by the social security beneficiaries will have to come out of the future national total of such goods and services.

In rejoinder, we are in complete agreement with the statement in the second paragraph that the "future goods and services consumed by the social security beneficiaries will have to come out of the future national total of such goods and services." But we believe that our correspondent has missed the point in the first paragraph.

As we see it, future taxes will be necessary to pay for the benefits of persons not yet on the rolls, *whether or not* there is a reserve fund. If there is not a reserve fund, such benefits will be paid out of future social security taxes directly. If there is a reserve fund, they will be paid out of future interest payments on the government bonds held in the reserve, which in turn must be provided by future taxes. In either case, future benefits will be paid out of future taxes, directly or indirectly.

Nor can we go along with our correspondent in asserting that "the benefits of persons already on the rolls . . . are now being paid out of taxes previously collected." On the contrary, it seems clear that such benefits are being paid partly out of social security taxes *currently* collected and partly out of interest on government securities accumulated in the reserve. Such interest, of course, is part of the present cost of servicing the national debt, and is paid, not out of past tax collections but out of *current* collections.

On the same general point is the following from another reader:

> The point of increasing (social security tax) rates would seem to be: is this gigantic pension system to approach actuarial soundness or is it going to pile up payroll taxes on future generations of workers which will be unbearable.

Here the answers would appear to be: First, whatever the original intent, the plan has — by its various amendments — already shifted from one where, as in insurance company operation, reserve funds are accumulated to meet fully the eventual liabilities, to one where a substantial portion of the benefit payments, as they come due, is paid out of current tax collections. Second, the burden of taxes on "future generations of workers" will be determined primarily by the liberality of benefits voted, rather than by whether the taxes are raised directly under a pay-as-you-go system or indirectly by being channeled through government securities held in a trust fund.

Another question had to do with the effect of drawing upon accumulated reserves in the trust fund. As the question was phrased —

> Is there any provision in the social security law which prevents drawing down the invested surplus in the trust

when the benefit payments approach their maximum and the annual receipts of taxes do not cover them?

If this be so, how can you dismiss the $18 billion surplus and say "future pension payments . . . can only be made out of taxes on the income of the future"? The Treasury, to meet its obligations to this trust, might have to sell bonds somewhere else. Then future pension payments would be made out of taxes of the past.

In case of necessity, the Treasury might, as our correspondent suggests, redeem its obligations from the trust by selling its bonds elsewhere; or, to the extent that marketable bonds might be held by the trust they could be sold to the general public. It was never contemplated, however, that the trust fund would be liquidated.

Effect on the National Debt

Some readers brought up the question of the effects of the trust fund upon the national debt. As one writer puts it:

Insofar as outstanding obligations of the Treasury are acquired out of money raised through taxes and the obligations so acquired (or others substituted for them) are placed in the trust fund the Treasury has in effect accomplished to that extent a reduction of its outstanding liabilities. Does not this process operate in effect as a sinking fund or amortization of the national debt?

Another writer makes the same point:

Irrespective of the legal status of the trust fund, the intention of the Congressional act, and our present objectives with respect to the act (as to whether the fund should be on a pay-as-you-go basis, a contingency reserve basis, or the reserve fund principle), the direction of the amendments to the law and the continued excess of receipts over expenditures have in effect contributed to the reduction of the national debt.

Since in the original article the main idea we were trying to get across was merely that high social security taxes and a huge reserve fund are not essential to a "sound" system, we did not go into many ramifications of the present set-up, including the effect on the national debt.

Our correspondents, however, are correct in pointing out that the process of taking in more social security money than is paid out, and investing the excess in the Government's own obligations, has operated in the manner described. To the extent that the taxpayers have borne this extra burden it has had the effect of reducing the "net debt" — or rather, to describe it more precisely, of limiting its increase — despite the continuing high level of total government expenditures.

While we would certainly not advocate such a course, by reason of the widespread public misunderstanding of what is really involved, the fact is that the $18 billion of government obligations held in the trust fund as of June 30, 1953 could be cancelled, and the national debt thereby reduced (incidentally solving at one stroke the problem of the debt limit), without robbing the social security beneficiaries of a single penny. As we stated before, the money collected in social security taxes has all been spent anyway, and the government IOUs that have taken its place in the trust, while good, are no better than similar IOUs that might be sold were no trust fund in existence.

An example of the confusion in the public mind on this whole question appears in the following from one of our readers:

The fact that the surplus (of social security receipts over disbursements) is in government bonds has no bearing on the matter, for if the Government had not borrowed this $18 billion it would have had to borrow $18 billion somewhere else.

On the contrary, had social security taxes been counted as part of ordinary receipts (instead of being segregated as "trust fund receipts"), and had government budgetary totals been reported on the basis of aggregate cash intake and cash outgo, the deficits shown would have been correspondingly reduced, and the $18 billion which now represents the cumulative bookkeeping result of social security transactions would never have had to be borrowed at all.

Debt Retirement a Good Thing

The foregoing should not be taken to mean that the practical result of the trust fund in bringing about in effect a retirement of debt has not been good. During the period of prosperity the country has enjoyed since the end of World War II there has been far too little attention paid to the importance of developing a fiscal program that would provide for systematic debt retirement. But, given the necessary moral fortitude in the Administration, the Congress, and the people, this can be done by cutting expenditures and collecting enough taxes, without the complicated and cumbersome trust fund machinery.

Whatever added protection the trust fund gives to future social security pensioners stems not from its great holdings of government securities, but rather from its effect in accomplishing debt retirement, thereby strengthening the ability of the Government to meet obligations now outstanding and others still to come.

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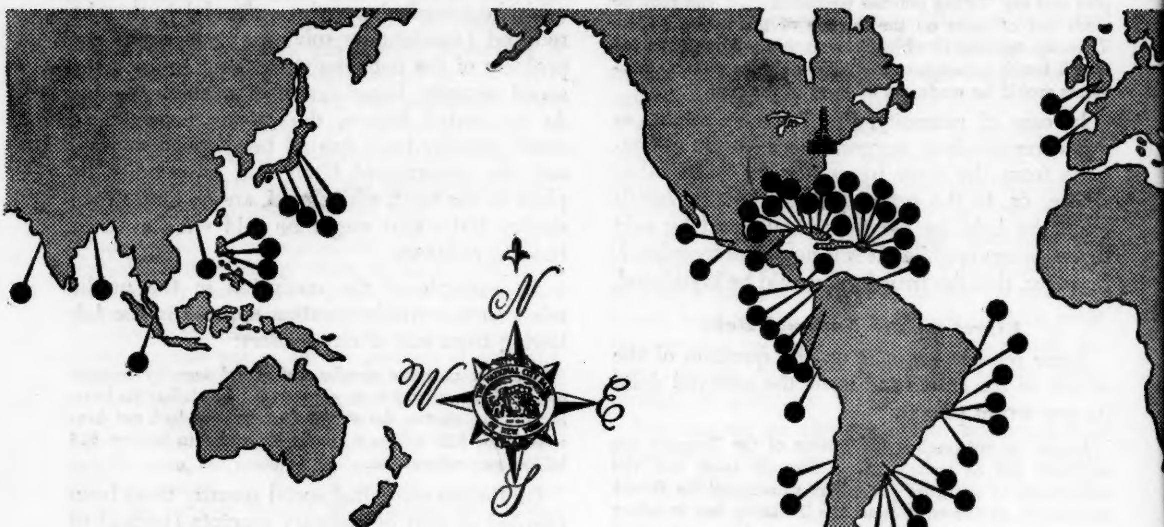

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